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COMMITTEE ON THE BUDGET

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Why Deficits Matter

Last month the House Budget Committee held a hearing on “Why Deficits Matter.” The purpose of the hearing was to develop a better understanding of why deficits pose a serious problem and why recent adverse trends must be reversed as soon as possible. We also sought to clarify the effects of tax cuts on the deficit.

The witnesses were U.S. Comptroller General David M. Walker (head of the Government Accountability Office), and two economists, Dr. Edward Gramlich (a former Governor on the Federal Reserve Board as well as former Acting Director of the Congressional Budget Office) and Dr. Edwin Truman (former Treasury Assistant Secretary for International Affairs in the Clinton Administration and a former Federal Reserve official). Below are some highlights of testimony from witnesses at the hearing.

Comptroller General Walker: “Deficits Matter for the World We Leave Our Children and Grandchildren” — The Comptroller General said that annual deficits and the rapidly accumulating public debt allow current generations to live beyond our means at the expense of future generations who will have to pay off that debt with higher taxes and/or lower government services. Comptroller General Walker testified that “today we are failing in one of our most important stewardship responsibilities – our duty to pass on a country better positioned to deal with the challenges of the future than the one we were given.”

The Fiscal Outlook Has Dramatically Deteriorated Since 2001 — In 2001, the Republican Congress and the Bush Administration inherited a projected ten-year (2002-2011) budget surplus of \$5.6 trillion. But today that positive outlook is long gone, replaced by a nearly \$3 trillion projected deficit over the same period – an astounding *\$8.4 trillion* swing to the red. Comptroller General Walker argued that this turnaround has dramatically impacted the long-term outlook (going out to the year 2040) as well. (See Figures 4, 5, and 6 in his written testimony available online at budget.house.gov/hearing_marks.htm)

Deficits Hurt Economic Growth— Dr. Gramlich emphasized that budget deficits represent negative public saving, which tends to drive down national saving (the sum of public and private saving); for part of 2005, even total national saving was negative. Lower national saving means a smaller stock of capital for the future, which reduces the productivity and wages of future workers. As a result, budget deficits lead to less economic growth and a lower level of economic activity than would otherwise be the case.

Recent Deficits Have Been Financed Almost Entirely with Foreign Capital — Despite the record-setting deficits experienced in recent years, interest rates have remained historically low because of the combination of accommodative monetary policy and an accelerating inflow of foreign capital. Dr. Truman testified that foreign investors “accounted for virtually the entire increase in the total holdings of all U.S. long-term securities, including equities and corporate bonds, from 2000 to June 2005.” Total foreign holdings of U.S. public debt have more than doubled under the Bush Administration. As that debt is paid down in the future by our children and grandchildren, the payments (coming out of their income) will be flowing abroad rather than to other Americans. Dr. Truman testified that our dependency on foreign funding is making the U.S. economy more vulnerable to a “hard landing,” where a pull-back of foreign investment would lead to shocks to the dollar, interest rates, and the stock and housing markets.

Discipline Must Apply to Both Sides of Budget — All three witnesses acknowledged that a big long-run fiscal challenge is the rapid growth in entitlement spending associated with the retirement of the baby boomers and rising per capita health care costs. But all three also agreed that the Bush tax cuts have been costly, and that current deficits must be eliminated by applying discipline to both the revenue side and the spending side of the budget.

If you would like more information about deficits or this hearing, please do not hesitate to call the House Budget Committee staff at 6-7200.